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No. 87-1142

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

ILLINOIS DEPARTMENT OF REVENUE and
ROGER SWEET, Director of Illinois Department of Revenue,
Petitioners,

v.

STEPHEN J. ANDRAS and BETTY I. ANDRAS and TRUST FOR SHORT-TERM U.S. GOVERNMENT SECURITIES,
Respondents.

On Petition for a Writ of Certiorari to the Illinois Appellate Court, Second Judicial District

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BRIEF FOR RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

Does Rev. Stat. § 3701, as amended in 1959, exempt from State income taxation distributions from a registered investment company (mutual fund) to its individual shareholders which consist of interest on U.S. government obligations, where the fund invests primarily in such obligations and regularly pays out its entire net income to its shareholders?

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BRIEF FOR RESPONDENTS IN OPPOSITION

STATUTE INVOLVED

Rev. Stat. § 3701 (31 U.S.C. § 742),[1] as amended by § 105(a) of the Act of Sept. 22, 1959, Pub. L. No. 86-

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[1] 31 U.S.C. was not enacted into positive law until 1982. By Pub. L. No. 97-258, 96 Stat. 877, enacted September 13, 1982, Congress "restate[d] in comprehensive form, without substantive change, certain general and permanent laws related to money and finance and * * * enact[ed] those laws as title 31, United States Code."

[Continued]

346, 73 Stat. 622, provided at the time pertinent to this case:

> All stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

STATEMENT OF THE CASE

We accept petitioners' Statement of the Case, set forth at Pet. 3-5.[2] We stress, however, that the Declaration of Trust establishing respondent Trust For Short-Term U.S. Government Securities ("Trust") provides that its shareholders are the beneficial owners of the Trust's assets. Article III, § 1 provides:

> The beneficial interest in the Trust shall at all times be divided into transferable Shares, without par value, each of which shall represent an equal proportionate interest in the Trust with each other Share outstanding, none having priority or preference over another. [Taxpayer Ex. No. 5.]

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[1] [Continued]

H.R. Rep. No. 97-651, 97th Cong., 2d Sess. 1 (1982). Rev. Stat. § 3701 became 31 U.S.C. § 3124(a) (Act of Sept. 13, 1982, Pub. L. No. 97-258, 96 Stat. 945). It is this re-enacted statute which petitioners quote at pp. 2-3 of their Petition. However, because the State tax at issue here was levied in 1980, the former Rev. Stat. § 3701, as amended, rather than the present 31 U.S.C. § 3124(a) (1982 ed.), technically controls this case. Cf. *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. 855, 859 n.1 (1983).

[2] Throughout this brief, "Pet." will refer to the Petition for a Writ of Certiorari, "App." will refer to the Appendix to the Petition, and "Am. Br." will refer to the Brief *Amici Curiae* of the States of California, *et al.*

Article IV, § 8 provides that although legal title of the Trust's assets is vested in the trustees, and

> [n]o Shareholder shall be deemed to have a severable ownership in any individual asset of the Trust or any right of partition or possession thereof, * * * each Shareholder shall have a proportionate undivided beneficial interest in the Trust. [*Id.*]

REASONS FOR DENYING REVIEW

I. Every Court to Address the Issue Presented Has Ruled in the Taxpayers' Favor

Petitioners observe that the issue which they "present for review is a federal constitutional and statutory question that has been litigated or is presently being litigated in state courts throughout the nation." Pet. 6 n.2. They fail to point out, however, that all courts which have decided this question—including appellate courts in four other States[3]—have ruled, in accord with the decision below, that under Rev.Stat. § 3701, a State "may not include in [a] taxpayer['s] gross income the dividend income received from [a mutual fund like] the Trust which is attributable to its holdings in U.S. Government Securities." App. 6.[4] Since petitioners proffer a position which has been widely and uniformly rejected, review by this Court is simply not warranted unless and until

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[3] In addition to the decision below, see *Brown* v. *Franchise Tax Board*, 242 Cal. Rptr. 810 (Cal. Ct. App. 1987); *Commissioner of Revenue* v. *Plymouth Home National Bank*, 394 Mass. 66, 473 N.E. 2d 1139 (1985); *Matz* v. *Department of Treasury*, 155 Mich. App. 778, 401 N.W. 2d 62 (1986); *In re Sawyer Estate*, —— Vt. ——, —— A.2d —— (Dec. 11, 1987).

[4] See, in addition to the decisions cited by petitioners and the *amici* (Pet. Br. 6-7 n.2; Am. Br. 4), *Commissioner of Revenue* v. *Plymouth Home National Bank*, 394 Mass. 66, 473 N.E. 2d 1139 (1985); *Page* v. *Florida Dept. of Revenue*, No. CI 87-2586 (Cir. Ct., 9th Jud. Cir., Orange Co., Fla. Dec. 4, 1987).

the highest available court in some State reaches the opposite conclusion.[5]

II. No Substantial Question Is Presented

A. It is not surprising that the State courts have consistently ruled that mutual fund dividends attributable to interest on U.S. obligations are exempt from State income tax. That result is compelled by this Court's holding in *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. 855 (1983), that the tax exemption established in the operative statute, Rev.Stat. § 3701, as amended, is to be given its full effect in light of a 1959 amendment which added the following sentence:

> This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

Prior to the 1959 amendment of § 3701, this Court had "consistently held that [the statute] prohibited state taxes imposed *on* federal obligations, either directly, or indirectly as part of a tax on the taxpayer's total property or assets," but "did not prohibit nondiscriminatory taxes imposed on discrete property interests such as corporate shares or business franchises, even though the value of that discrete interest was measured by the underlying assets, including United States obligations." 463 U.S. at 858 (emphasis in original). Thus, when a State sought to impose a property tax on a corporation, the

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[5] Petitioners and their supporting *amici* observe also that the potential tax revenues affected are substantial. Pet. Br. 6 n.2; Am. Br. 3 n.3. Given the universal judicial rejection of their position, however, they cannot claim that the States are being deprived of the ability to reach income which they have reasonably expected would be part of their tax base.

statute required that U.S. obligations be eliminated from the tax base, but when a State sought to assess the shareholders on the shares which each owned, it was permitted to include the value of U.S. obligations held by the corporation in the tax base.

In *American Bank*, the Court held that in light of the 1959 amendment to § 3701, this formalistic distinction is no longer viable. The amendment was to be given its full effect:

> The exemption for federal obligations provided by § 3701, as amended in 1959, is sweeping: with specific exceptions, it "extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax."
>
> * * * *
>
> The language of § 3701 encompasses "every form of taxation," and is inconsistent with implied exceptions. [463 U.S. at 862, 864 (Court's emphasis).]

Accordingly, the Court concluded that Texas could not, in imposing a property tax on the bank *or its shareholders*, include the U.S. obligations held by the bank in the value of the shares.

Although the legislative history showed that the "catalyst" for the amendment was Idaho's attempt to tax interest on U.S. obligations by asserting that its tax was not on the exempt income but on the individual taxpayer, measured by his net income, the Court rejected the contention that the amendment was limited "to this specific problem." 463 U.S. at 865, 867. "Nor," said the Court, "can the 1959 amendment be read to apply only to income taxes; it reaches '*every* form of tax . . .' ". *Id.* (Court's emphasis). In short, the Court held that "Congress intended to sweep away formal distinctions and to invalidate all taxes measured directly or indirectly by the value of federal obligations, except those specified in the amendment." *Id.*

B. Despite the broad interpretation of § 3701 in *American Bank*, petitioners assert that the "principle of separation between entities and individuals owning interest in such entities" should be recognized here, and that because of this distinction the tax-exempt character of the income on federal obligations cannot be passed through to shareholders in the absence of specific statutory authorization. Pet. 8. In so arguing, petitioners ignore the fact that *American Bank* involved a tax *on shareholders*, although the bank in which they held shares was the legal owner of the U.S. obligations. Thus, the distinction on which petitioners' case depends "was erased" in *American Bank*. *Brown* v. *Franchise Tax Board*, 242 Cal. Rptr. 810, 812 (Cal. Ct. App. 1987).

The court in *Brown* was faced with a claim identical to that of petitioners here—that a State may impose an income tax on distributions by a regulated investment company to its shareholders which are directly traceable to the federal obligations because such tax is not on income from federal obligations but is, rather, on "dividends" paid by those companies to their investors. The State taxing authority argued that this distinction "flows from the general principle that 'a corporation is a nonconductor that cuts off connection between dividends to its stockholders and the corporate funds from which the dividends are paid.'" *Id.* at 813. The *Brown* court rejected the argument because it

> is reminiscent of the "formal but economically meaningless" distinctions which were previously held to permit taxation of bank shareholders even if the underlying assets were federal securities—distinctions which became untenable with the 1959 amendments to the federal statute. [*Id.* at 813, quoting *American Bank*, 463 U.S. at 858.]

The "nonconductor" theory is, of course, identical to petitioners' "non-conduit" theory. Pet. 7. On the facts of *Brown*, and those in the present case, the theory fails

also because it disregards the critical differences between a corporation and a mutual fund. On this point, the *Brown* court's reasoning is so apposite and lucid that it merits quotation in full:

> Moreover, as applied here, the "nonconductor" principle is less than "economically meaningless"; as a functional matter, it is wrong. The [Trust is] not [an] ordinary corporation[], but [a] registered investment compan[y] whose business is to provide a conduit for investment in federal securities by persons who might otherwise be unable or unwilling to enter that market. The ability to pool investments in such funds stimulates the market for such securities by lowering the minimum investment necessary to participate in a given type of security, spreading the risks and rewards associated with (for example) fluctuating interest rates, and providing greater convenience and liquidity than would often be realized with individually purchased securities. Congress expressly recognized the "conductor" role of such companies when it declared, in the Investment Company Act of 1940, that they are "*media* for the investment in the national economy of a substantial part of the national savings," which "may have a vital effect upon the *flow of such savings* into the capital markets." (15 U.S.C.A. § 80a-1(a)(4) * * *.)
>
> The constricting effect of this tax on a congressionally recognized conduit for investment capital must be weighed, together with the legislative goal of preserving the market value and investment attractiveness of federal securities, in subjecting this tax to the statutory test, i.e., whether the proceeds of federal securities are *directly or indirectly* taken into account in computing the tax. In this context, the [taxing authority's] claim that it is blind to the origin of the distributions paid to the plaintiff class, even if accepted, is without economic significance. Unless Congress directs otherwise, the distributions [such] companies pay to their investors must be considered as so closely identified with their source that

> the computation of the tax involves indirect consideration of federal obligations. [242 Cal. Rptr. at 813 (Court's emphasis, footnote omitted).]

The *Brown* court's understanding of the relationship between a registered investment company and its investors is clearly correct. Consistent with the Investment Company Act cited in *Brown*, this Court has observed that a mutual fund "is a pool of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." *Burks* v. *Lasker*, 441 U.S. 471, 480 (1979). The return on investment, in the form of interest income, inures only to the shareholders' benefit, for substantially all of it is distributed to them in proportion to their investment except for amounts used to pay expenses. Thus, the Declaration of Trust here expressly provides that shareholders are the beneficial owners of the Trust's assets proportionate to their investment; and substantially all of the Trust's net income is distributed to its shareholders. See pp. 2-3, *supra*.

Petitioners observe that the Trust, as a registered investment company, "is treated as a separate legal entity" under the Internal Revenue Code ("I.R.C."). Pet. 9, citing 26 U.S.C. (I.R.C.) § 852. But the presently pertinent point is that the Code generally adopts the "flow-through" approach in allocating taxes and exemptions between qualifying mutual funds and their shareholders. Thus, mutual funds which generally distribute all of their income to shareholders are not themselves taxed thereon; the federal tax on distributed income is payable by the shareholders. As petitioners recognize (*id.*), when Congress addressed the issue in 1976, it amended the Code to provide expressly that tax-exempt income from State and local obligations passes through to the shareholders. I.R.C. § 852(b)(5).[6] Senator Percy,

[6] So, too under I.R.C. § 853, where a mutual fund pays income, war profits or excess profits taxes to foreign countries on foreign securities, the foreign tax credit is passed on to the shareholders.

who was the sponsor of this provision—which passed without opposition—explained: "This proposal is wholly consistent with the concept of a mutual fund, under which the shareholders of the fund are considered, for tax purposes, as the actual owners of the fund's holdings, and the direct recipients of their share of the fund's earnings." 122 Cong. Rec. 26111 (Aug. 6, 1976).[7]

In introducing this provision, Senator Percy said:

> This amendment is a matter of simple equity. It allows individuals of moderate means to benefit from the tax-free nature of municipal bonds just as those who can afford to purchase such issues directly now do. This is consistent with existing law which allows shareholders in regulated investment companies to pay the tax on investment company income from

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[7] Petitioners, pointing to the specific provisions for pass-through of exemptions from federal income taxes, argue that in the absence of a specific provision for pass-through of the federal exemption from State income taxes, it must be inferred that the latter is not allowed. Pet. 8-9. The argument is fallacious. I.R.C. § 852(b)(5), enacted in 1976, deals with the exemption of interest on state obligations from federal income taxation. By contrast, Rev. Stat. § 3701 deals with the exemption of *federal* obligations and interest thereon from *State* taxes; the 1959 amendment was adopted in a bill dealing with management of the public debt, and it is accordingly classified under Title 31 U.S. Code. See p. 10 n.8, *infra*. Obviously, these provisions are not *in pari materia*, either in subject matter or time of enactment; therefore, no valid inference can be drawn by comparing the draftsmanship of § 3701 with the provisions of the Internal Revenue Code. More fundamentally, a pass-through of an exemption from federal income taxes must be "specifically authorized" (Pet. 8) because the general rule, stated in I.R.C. § 61(a), is: "*Except as otherwise provided in this subtitle* [the income tax portion of the Internal Revenue Code], gross income means all income from whatever source derived, including * * * [i]nterest." (Emphasis added.) The precise opposite obtains with respect to State taxation of federal obligations and the interest thereon: "The language of § 3701 encompasses 'every form of taxation,' and is inconsistent with implied exceptions." *American Bank*, 463 U.S. at 864.

> securities as though they had invested in the securities directly.
>
> Certain limited partnerships and trusts may now pass through the tax-free status of municipal bonds, but for several reasons this is not a viable alternative for small investors.
>
> Finally, and equally important, this amendment will provide a new and substantially broader market for municipal bonds. [122 Cong. Rec. 22728 (July 20, 1976).]

These points are equally valid with respect to the pass-through of the tax exemption of interest on federal obligations. Even as mutual funds provide a medium to small investors to purchase municipal bonds and other State obligations, so mutual funds like respondent Trust "provide a conduit for investment in federal securities by persons who might otherwise be unable or unwilling to enter that market." *Brown, supra*, 242 Cal. Rptr. at 813. Petitioners do not deny that the marketability of U.S. obligations—like those of the States—is enhanced if the tax exemption on the interest is available to the individual investors. This point is decisive because the 1959 amendment to § 3701 was adopted to preserve the investment attractiveness of U.S. obligations against formalistic approaches by the States.[8]

In addition to urging their "non-conduit" or "entity" theory, petitioners seek to avoid the precedential force of *American Bank* by pointing out that that case involved property taxes while this case involves income taxes. This is the converse of the argument made and rejected in *American Bank*, that the 1959 amendment applies

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[8] The amendment came into law as a provision in a major bill proposed by the Eisenhower Administration in the interest of effective management of the public debt and of enhanced marketability of obligations of the United States. See Public Debt Ceiling and Interest Rate Ceiling on Bonds: Hearings Before the House Comm. on Ways and Means, 86th Cong., 1st Sess. 76, 80 (1959).

only to *income* taxes such as that of Idaho. The answer here must be the same: "[T]he 1959 amendment * * * reaches '*every* form of tax'" except State inheritance and franchise taxes. 463 U.S. at 867 (emphasis in original).

At the end, petitioners resort to hypothetical "horribles" which they say could eventuate if their entity theory is disapproved. They posit situations in which an investor in the fund or other owner of tax-free obligations could assign the interest to a creditor and/or an employee, and assert that the tax-free character of the interest would thereby pass to the assignee. Pet. 11-12. The latter assertion, on which this argument is based, is simply wrong; the tax laws long ago solved the conundrum which petitioners pose. Notwithstanding the assignment, if the interest income were taxable, it would be taxable to the owner of the obligations (the assignor) and not to the assignee. *Helvering* v. *Horst*, 311 U.S. 112 (1940); cf. *Lucas* v. *Earl*, 281 U.S. 111 (1930). Therefore, it is the assignor alone who benefits when the interest is exempt from taxation. Neither the tax nor the exemption may be shifted. In Justice Holmes' words, the law disregards "the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 115. But there is no impermissible shifting when a mutual fund distributes to its investors the income from tax-exempt obligations "belonging to the individual investors holding shares in the fund." *Burks* v. *Lasker*, 441 U.S. at 480.

C. Observing that "Illinois, like each of the *amici* states, imposes an income tax on dividends from any legal entity that is taxable as a corporation" (Am. Br. 7), the brief *amici curiae* is devoted entirely to the proposition that dividends paid by a corporation should not be exempt from State taxes to the extent that those dividends are based on the corporation's income from inter-

est on U.S. obligations.[9] That brief disregards the fundamental differences between mutual funds like the Trust here, and corporations—most notably, the fact that the individual shareholders of the former, unlike shareholders of a corporation, have a proportionate interest in the fund. Thus, *amici's* concern about the taxability of corporate dividends is addressed to a case which is not now here, and which, for aught that appears, has never arisen. And since none of the authorities which *amici* cite deal with mutual funds, or are shown to pertain to them, they need not be discussed herein.[10]

Amici contend that allowing the exemption would "severely complicate the administration of their state taxes by requiring them to investigate the source of a mutual fund's dividends and to exclude from their tax bases any dividends that may be traced to the mutual fund's investment in federal obligations." Am. Br. 3. Although it appears from their own survey that 28 States exempt this income (Am. Br. 5-6), the *amici* fail to show that administrative difficulties have resulted.[11] Indeed, their concerns are entirely unrealistic, since the States can impose on their taxpayers reasonable burdens to iden-

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[9] *Amici* observe that Illinois taxing authorities have "determined that the Trust is taxable as a corporation under Illinois law." Am. Br. 7 n.9. But, as the court below correctly observed, "where the issue is whether, or to what extent, a Federal right or immunity applies, a State Department of Revenue's categorization of its own tax is not controlling." App. 6, citing *First Agricultural National Bank* v. *State Tax Commission*, 392 U.S. 339, 347 (1968), and *Society for Savings* v. *Bowers*, 349 U.S. 143, 151 (1955).

[10] *Amici* argue: "The tax is not measured by the income or assets of the corporate payor; it is a tax on the investor's income, including the corporate dividend." Am. Br. 7. The identical argument was presented to the California Appellate Court in *Brown* and was rejected in the last paragraph quoted at pp. 7-8, *supra*. *See also* 242 Cal. Rptr. at 813 n.5.

[11] Moreover, *amici* merely assume, rather than demonstrate, that administrative considerations are pertinent in construing § 3701.

tify the exempt portion of their dividends. Pursuant to the requirements of I.R.C. § 852(b)(5)(A), mutual funds which distribute dividends attributable to interest on State obligations now provide the equivalent information to their shareholders to enable them to claim the exemption from federal income tax discussed at pp. 8-10, *supra*.[12]

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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[12] Some such funds also notify their shareholders of the amount of dividends attributable to interest earned on the obligations of *each* State; this benefits residents of States which exempt the interest on their own obligations and allow pass-through of that exemption.